23

MR MIDDLETON

Hold

cc Mr Evans
Mr Britton
Mr Turnbull
Mrs Lomax
Mr Shields
Mr Davies
Mr Grice

MLR CUTS IN THE BUDGET

I sent you on 24 February a note on the implications for the forecast of cuts in MLR of 1 and 2 points in the Budget. Since then there have been changes both to the underlying forecast (e.g. the coal settlement, various PSBR items, foreign interest rates, the FST's adjustments) and the package. The net effect is to suggest that MLR can be cut to 12% in the Budget while at the same time meeting the 8% target for £M3. Of course there are the risks we are all familiar with, but the changes to the post-Budget forecast effectively mean that the note ought not to be sent up in its original form.

2. In fact I doubt whether a separate note is needed at all, and I suggest you simply include an appropriate paragraph or two in your own minute. I suggest the following:

> "The post-Budget forecast reported to you on 18 February by Mr Evans has now been updated to take account of the agreed changes to the package, and the suggestions made by the Financial Secretary. Although of course the monetary outlook is still very uncertain, and the increase in income tax makes the achievement of a £3 billion inflow into National Savings that much more difficult, the forecast does now suggest that a 2 point cut in MLR in the Budget should be consistent with the achievement of the 8% target for £M3. M1 growth through the year is forecast at about 14%.

1996/2

3560/81

24

But if a 2 point cut were implemented now, £M3 would probably grow faster in the first half of 1981-82 than in the second half, partly as a result of the expected profile of the PSBR. The first few months of the new target period could well be characterised by monetary growth some way above the top end of the target range, and there would probably be no scope for further cuts in MLR during the course of the year. Although of course one cannot be at all confident of the quarterly path of the PSBR and monetary growth, or of the short run effects of interest rate changes, a smaller cut in MLR in the Budget - say 1 point - followed by a further cut later in the year would probably mean smoother monetary growth through the year. This might also have the advantage that holding out prospects of further interest rate falls through the year would help to maintain favourable expectations in the gilt market."

3. I also attach a paragraph by Stephen Davies on the impact of interest rate changes on the company sector's financial position which you might also include in your minute.

CJR

C J RILEY
27 February 1981

25

We estimate that a 1 point reduction in short term interest rates in the Budget would reduce industrial and commercial companies' interest payments net of interest receipts by about £280 million during 1981-82, before allowing for the effects of a reduction in interest rates on the amount that companies actually borrow. The Bank have provided a similar estimate. However in practice we would expect the decline in interest rates to lead to some increase in companies' borrowing and this would reduce the change in their net interest payments to nearer £200 million. But the financial position of companies would also benefit from the general stimulus to activity and company profitability brought about by a reduction in interest rates. After allowing for this and some consequent increase in companies' expenditure we would expect the net improvement in industrial and commercial companies' cash flow to be of the order of £250 to £300 million.